

## Farm Finance



Jack Harrison

## Farm Credit Use Up for 5th Straight Year

### Market Stronger for Farm Lenders

**D**emand for farm credit is expected to increase again in 1997 after growing since 1992. Total farm business debt—real estate and nonreal estate loans—is forecast to reach about \$160 billion by the end of 1997, up about 2.7 percent from 1996 and the highest since 1985. This marks the seventh annual increase in the last 8 years, which followed 5 successive years of net debt retirement. Continued economic growth, relatively strong field crop prices, and increased farm incomes in 1996 are behind much of this year's expected expansion.

At the end of 1996, total farm business debt was \$155.5 billion, up 3.1 percent from a year earlier. The increase in 1996 is the second-largest annual percentage gain in outstanding loans since 1982 and pushes the debt level to about \$17.6 billion above the 1989 low. Since 1993, farm debt has expanded faster than the

rate of inflation, unlike the previous 4-year period.

The recent increase in farm debt is important to watch, but not a particular cause for concern, because the overall farm sector is in good financial health. On average, farmers are expected to take on just 60 percent of the debt that could be supported by projected incomes. In addition, total farm debt at the end of 1996 is still a solid 20 percent below 1984's peak. In percentage terms, increases in total farm debt in the 1990's have been well below the double-digit expansions of the 1970's.

Continued growth in loan demand contributed to the strong financial condition of most commercial agricultural lenders in 1996, and these lenders are expected to be in a strong position in 1997. However, changes in loan volume and the composition of loan portfolios vary among each of the four institutional farm lenders—commercial banks, the Farm Credit System (FCS), the Farm Service Agency (FSA), and life insurance companies.

Together, these four classes of lenders accounted for about 77 percent of all farm loans in 1996. The remaining share of farm credit comes from individuals and from nontraditional lenders, primarily input and machinery suppliers, cooperatives, and processors. Outstanding loan volume for all farm lenders increased in 1996, except for the government "farm lender of last resort"—the Farm Service Agency (FSA)—which accounted for 6 percent of all farm business loans in 1996.

Commercial banks are the largest source of farm business credit, accounting for 39 percent of all farm loans in 1996. Total outstanding farm loan volume by commercial banks reached \$61.2 billion in 1996, up \$2.5 billion, or 2 percent, from 1995. The FCS—a collection of federally chartered borrower-owned credit cooperatives that lend primarily to agriculture—held total farm business loans of \$39.9 billion at the end of 1996, up 6.8 percent from a year earlier. For life insurance companies, which are active in farm real estate mortgage lending, total farm loans rose just 0.8 percent during 1996, but are expected to grow about 2 percent in 1997.

### Nonreal & Real Estate Loans Are Up

Agricultural lenders generally found the demand for farm credit strengthened across the board in 1996. Real estate, nonreal estate, and total outstanding loan volume categories each increased just over 3 percent.

*Nonreal estate loan volume* rose \$2.3 billion, or 3.2 percent, in 1996. Nonreal estate loans, typically used for farm inputs, equipment, and machinery, accounted for about 50 percent of the total 1996 growth in farm loan value—a change after lagging behind real estate loan growth rates in recent years. Outstanding FCS nonreal estate loan volume increased \$1.3 billion, or 10 percent, compared with \$157 million, or 0.4 percent, for commercial banks.

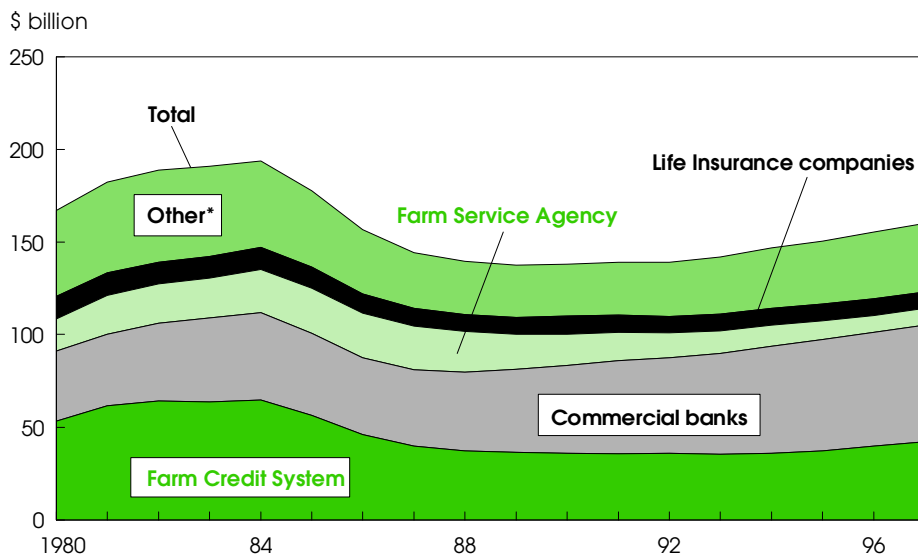
Demand for nonreal estate farm loans should increase 3-4 percent in 1997. Farmers are expected to increase expenditures on inputs—fuel and seed prices will be up from 1996. Partially offsetting is an expected decline in area planted to major crops because of lower prices at planting time. Total planted acres for the eight major crops (wheat, rice, corn, sorghum, barley, oats, soybeans, and cotton) are expected to decrease by about 5 million acres in 1997.

Strong farm machinery sales help maintain the demand for short- and intermediate-term farm loans. Sales of farm tractors, combines, and other farm machinery were strong in 1996. Tractor sales are forecast to be up again in 1997, but by a smaller margin, and overall demand for machinery is anticipated to be steady to higher. A rising share of loans for farm equipment and machinery is now met by "captive" finance companies owned by the machinery companies, rather than by traditional institutional lenders.

*Farm real estate farm loan volume* rose \$2.5 billion, or 3.1 percent, in 1996. Outstanding FCS real estate loans accounted for \$1.3 billion of the rise, while commercial banks gained \$1 billion. FCS long-term real estate loans increased 4.1 percent during the year ending September 30, 1996, reflecting increased

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### Farm Debt to Reach \$160 Billion in 1997



\*Debt to individuals and others, including merchants and dealers.

Economic Research Service, USDA

demand following a period of decline or stagnation for its mortgage credit.

Real estate loan volume should increase 2-3 percent in 1997. Brisk activity in the land market should create stable demand for mortgage loans in 1997. Per-acre U.S. farmland values increased 7 percent in 1995 and rose an estimated 6 percent in 1996. Values are expected to advance 5.5 percent in 1997, marking 11 straight years of U.S. farmland value increases.

From 1987 to 1991, growth in U.S. farmland values had lagged the rate of inflation. But since then, farmland values increased 25 percent compared with a 10-percent rise in overall prices. Moreover, the 1992-96 increases represent the strongest yearly gains, both in nominal and real terms, since the farm-sector recovery began in 1987.

### FCS Market Share Has Rebounded

While farm credit has risen during most of the 1990's, substantial changes have occurred in farm business debt market shares among the four classes of institutional farm lenders, as well as in the composition of loans made by each class.

The interplay between two important lender classes—commercial banks and the FCS—is particularly notable.

The FCS has demonstrated financial strength in recent years after undergoing massive restructuring of its organization and procedures. The FCS has access to national money markets and can help provide needed farm credit at competitive rates.

Commercial banks' *total farm loan* portfolio grew 49 percent during 1987-96, while the FCS portfolio dropped 45 percent from a 1982 high to a 1993 low. The farm financial crisis of the early 1980's adversely affected the FCS, causing many farmer-borrowers to leave because of fear they could lose their stock in failed FCS units. Commercial banks also experienced financial stress but were able to compete effectively in the aftermath of the crisis to build market share.

FCS operating costs and net interest margins (i.e., the difference between rates charged to borrowers and FCS's cost of funds) have remained high compared with the pre-crisis level. But FCS market share increased both in 1995 and 1996 after trending downward since 1982.

Commercial bank share, on the other hand, declined in 1996 following a 14-year increase. During 1994-96, FCS farm lending grew 11 percent (\$4.1 billion) while commercial bank farm loans increased only 6 percent (\$3.4 billion).

For *real estate debt*, the value of outstanding loans held by commercial banks more than tripled (up \$15.7 billion) between the 1982 low and 1996. As banks required higher loan collateral in the wake of the 1980's farm financial crisis, new bank farm credit lines were backed by real estate, which shifted some production loans to the real estate category.

In contrast, FCS real estate loans decreased 47 percent (\$22 billion) from their 1984 high to a 1994 low. The FCS real estate loan portfolio has declined in 9 of the last 12 years while the FCS market share of these loans fell from 44 percent in 1984 to 31 percent in 1995. But in 1996, the FCS's real estate lending market share increased for the first time following an 11-year decline to 32 percent.

The *nonreal estate loan* portfolio of the FCS increased 57 percent (\$5 billion) from the 1988 low to 1996, and commercial banks' nonreal estate loans increased 37 percent (\$10.3 billion) from their 1987 low. This growth was the result of a recovery in demand as the farm sector grew following the farm financial crisis. In 1996, the FCS held 19 percent and commercial banks held 51 percent of total nonreal estate debt.

The FCS has shown recent gains, however, vis-a-vis the commercial banks. FCS nonreal estate market share has grown for 3 consecutive years, while commercial banks' share of the market has declined for 2 years. During 1993-96, FCS nonreal estate lending increased 30 percent (\$3.2 billion), while commercial banks' increased only 8.5 percent (\$3 billion).

In 1997, FCS total farm business debt is forecast to increase about 5.5 percent following a rise of almost 7 percent in 1996. FCS mortgage debt is expected to rise about 4 percent in 1997, the first significant gain since 1984, and FCS nonreal estate loans are forecast to rise over 8 percent in 1997.

## **Lenders Respond To Heightened Demand**

Farm lenders have responded to the increased demand for loans that began in 1993. From year-end 1992 through year-end 1996, total farm debt grew \$16.4 billion, or 12 percent. Commercial banks led with \$9.5 billion, followed by the category of individuals and others, with \$6.6 billion, and the FCS, with \$4.1 billion.

The recent growth in farm loan demand experienced by commercial banks is reflected in their loan-to-deposit ratio, a common measure of a bank's lending capacity—the lower the ratio, the greater the bank's lending capacity. Average loan-to-deposit ratios grew to 67.4 percent for agricultural banks at the end of fiscal 1996, up from 59.7 percent 3 years earlier. Average loan-to-deposit ratios reported by the Federal Reserve System for agricultural banks increased in five of the eight reporting Federal Reserve districts. The Minneapolis and Kansas City ratios are the highest in 15 years, and the Chicago ratio is the highest since the late 1970's.

The growing demand for farm loans and increasing farm loan-to-deposit ratios at agricultural banks might appear to have taken much of the slack out of the farm lending system. But this has not generally been the case. High loan-to-deposit ratios do not necessarily constrain the origination of new loans. Commercial banks have many nondeposit sources of funds, and profitable, well-managed banks often have very high loan-to-deposit ratios.

Not all lenders will be able to expand credit to farmers in all loan categories. The FSA has authority for both direct farm lending, predominantly for operating loans, and loan guarantees. Under a guaranteed loan, FSA agrees to guarantee repayment of up to 90 percent (95 percent in some cases) of an approved loan made by a commercial lender.

FSA-guaranteed lending volume was \$1.85 billion in fiscal 1996, down 4.5 percent from 1995, and accounted for 69 percent of the agency's farm lending activity. Direct lending was \$832 million—low compared with direct loan levels before fiscal 1990. Adjusted for inflation, direct lending is now the lowest since the predecessor Farmers Home Administration was created in 1946.

The availability of direct FSA loans to family-sized farmers unable to obtain credit elsewhere continues to fall as the agency emphasizes guaranteed loans. FSA's predecessor agency began to emphasize guaranteed over direct government loans in the early 1980's. During fiscal 1995-96, outstanding direct loan volume fell by almost \$1 billion, while outstanding guaranteed volume rose by \$427 million. Direct loan authorities continue to be under added budget restraint, and the direct loan portfolio should continue to shrink for the foreseeable future.

FSA's direct lending program market share of total farm debt is now at the 1977 level. The decline in FSA's direct loan market share was largely the result of large loan writeoffs and reduced new lending activity.

FSA's loan demand in 1997 is difficult to predict because it depends in part on the extent of adverse weather as well as on economic conditions that affect the farm sector. FSA total farm loan authority is up 6.8 percent in fiscal 1997 and should be sufficient to meet demand for most programs. Guaranteed loan authority is up 22 percent to \$2.5 billion.

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As *AO* went to press, the Federal Reserve raised its key short-term interest rate by a quarter of a percentage point. This puts the Federal funds target rate for overnight loans between banks at 5.5 percent.

## **Ample Credit Available in 1997**

Credit availability should be ample for agriculture and rural business borrowers in 1997, while interest rates may rise slightly by the second half of 1997. Farmers and other rural borrowers are benefiting from rural lenders' increased willingness to grant loans as well as a continued relatively stable interest-rate environment.

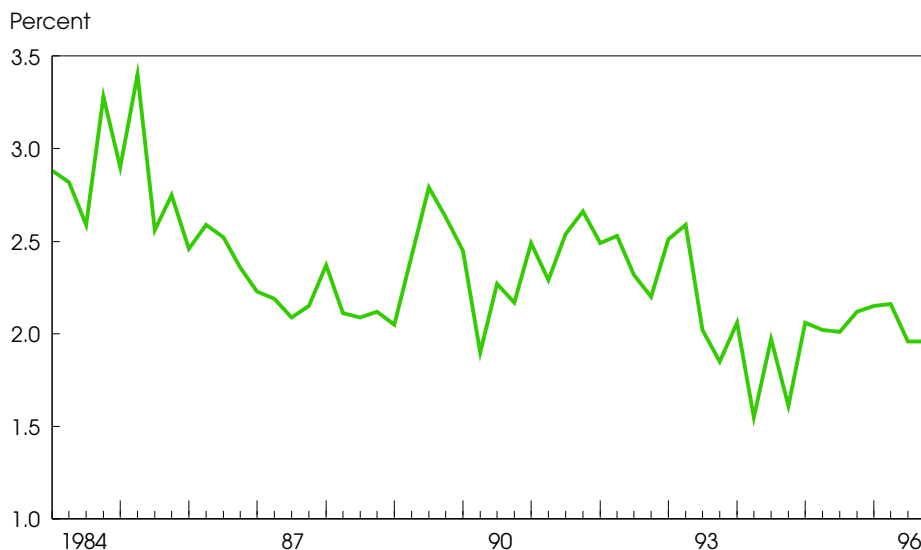
Because commercial banks are the largest category of lenders to agriculture and small businesses, the availability and cost of bank loans to agriculture and rural small businesses is an important factor in determining the near-term outlook for rural growth. The Farm Credit System also appears well capitalized and is willing to lend to creditworthy farm borrowers.

Stable interest rates and greater debt-fund availability benefits rural businesses by reducing their financial risk and cost of borrowing money. When there is uncertainty in the cost and availability of debt, business firms that borrow money are exposed to increased financial risk. As a firm's use of debt rises, overall fixed expenses increase, and when interest rates fluctuate, this leads to greater variability of net income. In the event of a sharp contraction in operating income or the ability to finance existing debt, business firms are more vulnerable to the risk of less credit availability and higher costs for obtaining and maintaining debt and equity capital.

Fortunately for agricultural and rural borrowers, credit availability has continued to improve in 1997. The Federal Reserve Senior Loan Officer Survey indicates commercial banks in the first quarter of 1997 have continued to ease credit standards for business lending, including credit standards for small firms. Likewise, for the fourth quarter of 1996, roughly half of rural banks heavily involved in agricultural lending had loan-to-deposit ratios lower than desired, according to the Federal Reserve survey of these banks.

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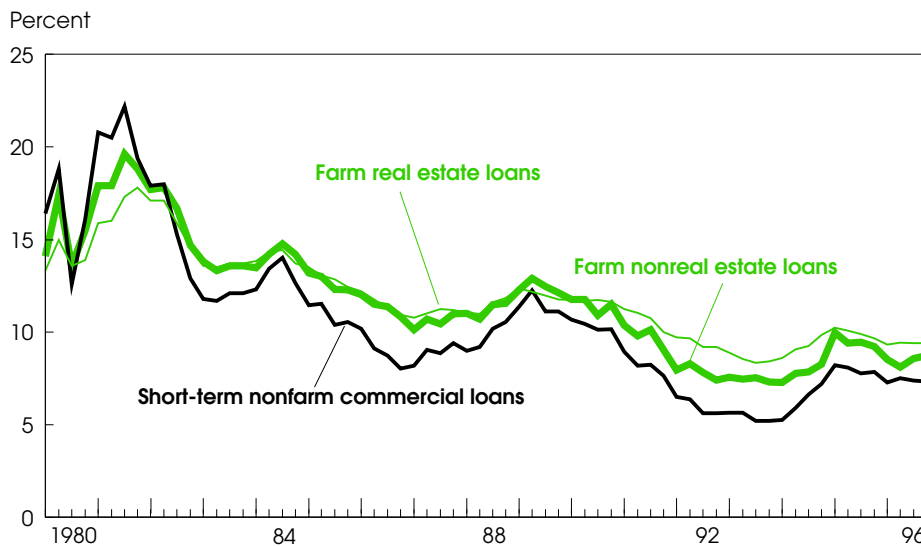
### Bank Business Loan Spreads Have Narrowed in the Last Decade



The average rate for commercial and industrial loans (2-12 months maturity) charged by banks, minus the average rate for 3-month large certificates of deposit paid by commercial banks (cost of funds).

Economic Research Service, USDA

### Interest Rates Have Been Less Volatile in the 1990's



Economic Research Service, USDA

The easing of credit standards and the desire to expand business lending has led to a narrowing of business lending spreads as well as greater availability of funds for business lending. Business lending spreads are measured as the difference between the loan rate charged by the bank and 1) the base lending rate the

loan is tied to (often the prime rate) or 2) a bank cost of funds (e.g., the Federal funds rate or a large certificate of deposit rate). Last year's trend toward smaller lending spreads and greater credit availability for business lending is expected to continue through 1997.

Lower lending spreads in 1997 for rural bank lending are due in part to strong profitability for agriculture and other rural industries in 1996, which strengthened business balance sheets and the value of their loan collateral. Because of stronger rural borrower balance sheets and increased bank willingness to lend, risk premiums on rural bank loans are likely to continue to fall in 1997. A continued slowdown in the growth and availability of consumer credit from commercial banks is expected, due to continued high and rising consumer debt burdens and consumer loan default rates. This should further expand bank funds available for business lending.

### *Lending Rate Volatility Declines in the 1990's*

Agriculture lending rates from commercial banks have been less volatile in the 1990's than in the 1980's, which has been beneficial for both farm borrowers and farm lenders. Both farmers and lenders make decisions based on expected capital costs, risk, and expected levels and movements in interest rates. For farmers, such decisions include whether to invest in new farm capital now or later. For lenders, business decisions might include the amount and type of debt capital to raise. Borrowers must decide whether to finance assets primarily with long-term debt, such as long-term fixed rate loans, or with short-term or variable rate loans.

Large unanticipated movements in interest rates can have large impacts on the financial well being of borrowers and lenders. But in a relatively stable interest rate environment like the present one, movements in interest rates are likely to be relatively small, with fairly small forecasting errors that generate relatively little impact on borrowers and lenders. Furthermore, periods of stable interest rates with low inflation tend to increase the volume of long-term financing and reduce its cost.

Lenders benefit in periods of relatively stable interest rates—there is lower risk of sharp changes in the market value of existing bank assets and liabilities. Interest-rate stability also reduces the cost



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of lending in general, and farm lending in particular, by reducing the need to learn and apply complicated interest-rate-risk strategies (such as more closely matching the maturity of assets and liabilities or using derivative securities) or to engage heavily in the very inexact art of interest-rate forecasting. Because larger financial institutions are more able to afford and implement these asset and liability risk management strategies, a relatively stable interest-rate environment reduces the relative advantage large lenders have over small rural lenders.

### ***Farm Interest Rates May Rise Slightly in 1997***

Although risk premiums on agricultural and rural loans are determined primarily by profitability and risk in the agricultural sector, the sector is also influenced by the general level of interest rates. While accurate projection of interest-rate movements is extremely difficult, many analysts are forecasting a slight upward movement in the economywide interest rates in the second half of 1997. However, any increase in farm and rural lending rates at commercial banks and through the Farm Credit System is likely to be small.

Slower growth in credit demand in the nonfinancial sector (e.g., borrowing by consumers and by nonfinancial businesses) in the second half of 1996 should moderate upward pressures on interest rates in 1997. Nonfinancial credit grew at an annual rate of 5.8 percent in the first half of 1996 but slowed in the third quarter to 5.1 percent. Consumer credit growth slowed from 9 percent in the first half to 6.3 percent in the third quarter. Fourth-quarter nonfinancial credit grew just 4.5 percent as the growth in nonfinancial business borrowing slowed to 3.6 percent, and consumer credit growth slowed to 5.6 percent.

The direction of Federal Reserve policy is also uncertain in 1997, but Chairman Greenspan's late-February report to Congress pointed toward an increased likelihood of tightening monetary policy in 1997. The Chairman's testimony illustrated continuing Federal Reserve concerns over tight labor markets and very high stock market values that could generate increased inflationary pressures. But a substantial tightening of monetary policy is not likely in 1997 as long as economic growth slows and any increases in inflation are small.

Any increase in interest rates facing farm and rural borrowers is likely to be small in 1997 for several reasons. First, any increase in open market interest rates as a result of Fed action is likely to be small.

Second, rural banks are heavily dependent for loan funds upon consumer-type deposits, which typically adjust slowly to changes in open market interest rates. How aggressively banks compete for funds in times of rising interest rates depends upon many factors, including the strength of bank loan demand, the size of banks' surplus of loanable funds, banks' capital position, and whether the rise in open market interest rates is likely to persist.

Third, bank lending spreads are expected to continue to narrow in 1997. Fourth, the Farm Credit System has also shown a general reluctance to raise farm lending rates to match a rise in open market interest rates, especially in the short term.

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### **April Releases—USDA's Agricultural Statistics Board**

The following reports are issued electronically at 3 p.m. (ET) unless otherwise indicated.

#### **April**

- 2 *Broiler Hatchery*
- 3 *Dairy Products*
- 4 *Egg Products*  
*Poultry Slaughter*
- 7 *Crop Progress (after 4 pm)*
- 9 *Broiler Hatchery*  
*Vegetables*
- 11 *Crop Production (8:30 am)*
- 14 *Potato Stocks*  
*Crop Progress (after 4 pm)*
- 15 *Hatchery Production, Annual*  
*Milk Production*  
*Turkey Hatchery*
- 16 *Broiler Hatchery*
- 17 *Agricultural Chemical Usage,*  
*Field Crops*
- 18 *Cattle on Feed*  
*Cold Storage*  
*Sheep*
- 21 *Crop Progress (after 4 pm)*
- 22 *Chickens & Eggs*
- 23 *Broiler Hatchery*
- 24 *Catfish Processing*
- 25 *Dairy Products, Annual*  
*Floriculture Crops*  
*Livestock Slaughter*  
*Meat Animals—Production,*  
*Disposition, & Income*
- 28 *Crop Progress (after 4 pm)*
- 29 *Catfish Production*  
*Poultry—Production & Value*
- 30 *Agricultural Prices*  
*Broiler Hatchery*  
*Peanut Stocks & Processing*